The Right Real-Estate Strategy with Perfect Execution

By **Scott Simcik, CFE**

The foundation of franchising is standardization, uniformity and consistency. In-N-Out Burger, Chick-fil-A, McDonald's, Gold's Gym and Storage USA have each mastered the fundamentals of what role real estate processes have played in the quality of their brands. Whether a freestanding drive-thru, strip mall location, flex or industrial location, they have sourced and trained an exclusive and approved strategic partner providing best-of-class real estate service and systems for new, first-time franchisees.

These major brands have three essential core values and real estate systems that maximize the quality criteria of each location and reduce the total start-up costs, while negotiating the lowest annual occupancy revenue-to-sales percentage. These companies realize that a franchisee's ultimate financial net income and return on investment are highly dependent upon the quality of their real estate system, which might be even more important than the design, menu, products or services they sell within their locations. Any one missing element of location, start-up costs or annual rent can dramatically affect the stability and profitability of the franchised location. While franchisors are pre-planning activation of these real estate services immediately upon a franchisee signing the franchise agreement, a franchisee must also avoid these three (3) major mistakes prior to and after signing a franchise agreement:

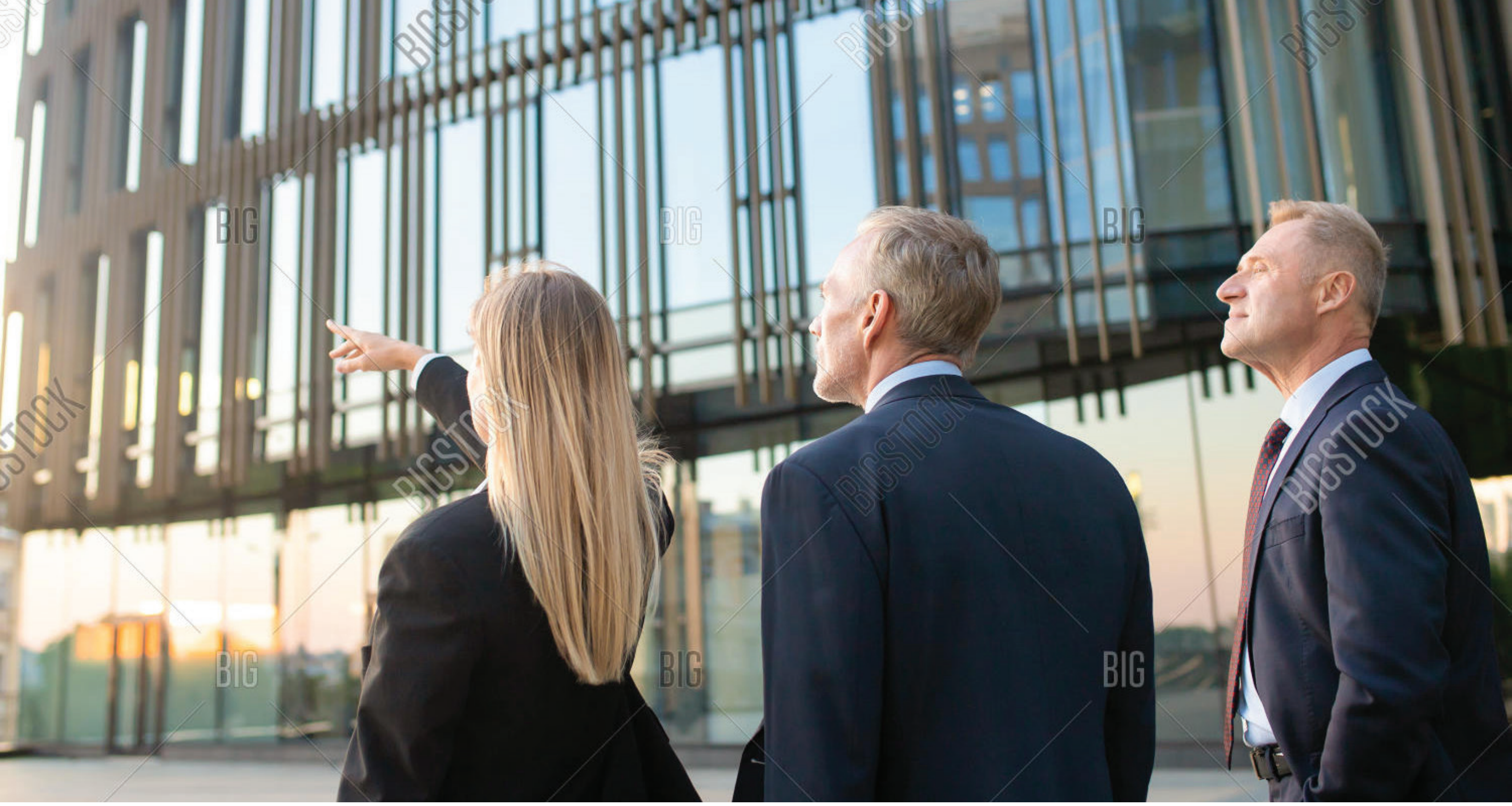
MISTAKE #1

Driving Local Corridors and Calling the Landlord Listing Agents on Pylon Signs

A first-time franchisee's excitement, enthusiasm, eagerness and/or overconfidence are the natural motivators to making the most costly financial mistakes. In an effort to find the highest-quality location, falling in love with the top 1, 2 or 3 locations and then calling the landlord listing agent to gather information and rates can, in almost every case, guarantee a potential financial loss of up to $300,000 in all aspects of the real estate process, including buildout, free rent, annual occupancy rates, paid landlord capital improvements, concessionary tenant improvements and all non-financial exclusive, use, signage and ADA (Americans with Disability Act) landlord bathrooms, sprinklers, parking, plumbing, lighting and electrical interior and exterior requirements.

Not only is a first-time franchisee jumping directly into the landlord sales net by calling on favorite locations; they are unknowingly granting permission to the landlord listing agent to use legal, yet unethical, dual representation and conflict of interest against a franchisee as a potential tenant. Additionally, there is an increased risk of overlooking up to 50% of potential new location opportunities both on and off the local market. Landlord listing agents await these direct calls from eager first-time and multi-unit franchisees knowing these are huge financial windfalls for a landlord. These listing agents know all too well that franchisees think they're saving a commission or are better financial negotiators. However, franchisees always end up on the losing side of negotiating leverage.

There is a rule of thumb in negotiations: *Always be the seller, never the buyer*. When a franchisee's behaviors include individually walking and talking to a landlord listing agent within a space, emailing for information, meeting GCs in the space and discussing and preparing incomplete offers, they reduce themselves to being a buyer, giving away all financial leverage with the risk of major structural oversights. Landlords take full advantage by shielding themselves from potential tenants, being represented by their experienced sales listing agent, who holds all of the negotiating leverage, and saving what can easily amount up to $300,000 in inflated and superficial market rates, capital improvements and would-be tenant improvement concessions. To add insult to injury, the listing agent has a contract with his/her landlord to keep the full unsplit commission if the franchisee is unrepresented. **Never directly call a landlord listing agent on a pylon sign, as it reduces you to becoming a BUYER without financial leverage!**



MISTAKE #2

Performing Ineffective Walkthroughs will Dramatically Increase Total Start-up Costs

First-time and multi-unit franchisees would have no reason to understand how much start-up capital can be lost on a simple walkthrough of their favorite spaces. After all, this is a once or twice in a lifetime experience. However, landlord sales listing agents perform up to 100-300 walkthroughs a year, over decades, and know exactly what friendly and casual questions to ask to gain an emotional and financial advantage over a franchisee. Sometimes, even being trained on ***what not to say*** on a walkthrough, and knowing its importance, innocent eager or over-confident emotions will be extracted from a seasoned landlord listing agent without a franchisee ever knowing, as one or two misused words or sentences will communicate everything a listing agent needs to know about how much a franchisee wants the space, what else they are looking at and who is the dominant driver of the final financial decisions.

Unlike residential real estate, in which a home is bought and sold from a different seller on each transaction, it's just the opposite in commercial real estate, as the same local agents work with the same landlord on multiple vacancies over and over, leasing spaces in the same property. This is an inherent financial liability for a franchisee because a franchisee is viewed as a one-off transaction, yet the local agents have worked together on possibly ten transactions before and will work on ten more after this franchisee's transaction. Who is more important: the individual franchisee's transaction or the long-term incomes of the two agents and the landlord's best financial interest? The issues below support how local agent politics can negatively impact a franchisee's start-up costs and long-term annual occupancy rates:

A. **A franchisee will never hear any local agent state to the opposing landlord listing agent on a walkthrough:** "This is a cold or gray shell, and the landlord is required to invest, as its own responsibility, the capital improvements to bring the interior space to a complete and rentable vanilla shell condition." Local brokers will NEVER use the term "capital improvements" in a franchisee's presence on the walkthrough; however, they will limit any conversation to the term "tenant improvement allowance," which, in almost every situation, will not cover even fifty percent of a finished rentable vanilla shell.

B. **This is the local market rate and is used as a superficial negotiating term on walkthroughs between and with the mutual consent of local brokers (winking), knowing in commercial real estate there are no direct comparisons like residential (cookie cutter) homes in a neighborhood.** Each landlord varies with a different building age, purchase price, property taxes and interior conditioned property, each with higher and lower mortgages and varying vacancy rates, combined with local and institutional landlord financial return strategies. An adjacent shopping center can offer 40% lower and more competitive monthly rental rates simply because they're mortgage-free and want long-term tenants without turnover. Yet, franchisees are boxed into this local market rate thinking that, since they are considered a quick individual transaction, both local brokers need to protect the landlord to retain the listing agreement to lease their spaces. To save the most start-up capital, it's always in a franchisee's best interest to utilize an out-of-state financial negotiator who has no relationship with the local broker or landlord.

C. **"This is ALL the landlords will do in this market" is a superficial stonewalling term used by a local agent showing a franchisee a space, or both agents together on a walkthrough justifying this phrase by how well they both know this landlord.** This, alone, is a major **red flag**, yet franchisees think that if their agent knows and has worked with the landlord, it must be in their best financial interest. In fact, the broker is intentionally softening the financial offer that they advise to a franchisee, increasing a franchisee's capital start-up and rental costs because they are protecting the landlord's financial interest. Therefore, this landlord and listing agent will always be in favor of the soft offers from this cooperating agent on future transactions! The moment any agent says the above comment or claims to have a great relationship with the landlord or broker, they are communicating to a franchisee that the landlord's financial interests come before their own client's. This reinforces the term "local market rate offers" and promotes non-aggressive financial negotiations that are directly opposed, first and foremost, to the financial goals of protecting the long-term profit and sustainability of a franchisee's business!

MISTAKE #3

Costly Financial Mistakes Made During the Letter of Intent Negotiations Stage

The significance of how the financial terms are negotiated and with whom have a major impact on a franchisee's start-up cost, annual occupancy rates and sustainable long-term profit, including renewal periods. For example, if a franchisee is the WHO doing their own financial negotiating, it is almost certain that the landlord listing agent has both more experience and the financial leverage with an eager tenant who demonstrates a buyer mentality. Regardless of how it is disguised, landlord sales listing agents have had hundreds of these types of experiences and know the franchisee does not want to lose their favorite space and is not simultaneously negotiating on three spaces at the same time. Therefore, the landlord controls the market rate, shifts the landlord capital improvement costs to the franchisee and offers limited to zero tenant improvements, while easily rejecting buildout, rent abatement rental discounts and other non-financial yet important concessions. Furthermore, in almost all circumstances, first-time franchisees attempting to prepare their own

letter of intent make grave omissions related to permitting, use, sprinklers, HVAC, signage and exclusives, as well as other mechanical, electrical, plumbing and interior and exterior ADA requirements. After a lease is signed, it's too late. These financial mistakes unexpectedly surface and can put a tremendous strain on the budgeted working capital, ultimately causing a franchisee to unnecessarily invest much more start-up capital than expected to open their business.

The more traditional methodology that franchisees expect are two local agents doing the financial negotiating on behalf of a franchisee and landlord. The HOW they negotiate is where the costly financial mistakes occur. When two local agents are allowed to speak among themselves, a franchisee is always excluded from the sequence of these closed conversations, deferring to their agent as the trusted expert. If there is no transparency, a franchisee is only a third party, and local agents have worked on ten transactions before and will work on ten transactions after with the same landlords. It's clear who owns their financial loyalty—the landlord. A franchisee's local agent's unspoken obligation is to present soft financial offers to maintain local professional relationships.

A seasoned out-of-state financial negotiator will be twice as aggressive in saving a franchisee's capital if, in fact, each negotiating conversation is a transparent pre-letter of intent conference call inviting the franchisee to actively listen to the landlord listing agents regarding financial intent and negotiating delivery and experience. In this way, a franchisee's financial interest would be truly revealed and protected. Unlike residential buyer/seller agent practices, which include an offer with home inspection contingencies, commercial spaces are offered in cold, gray, vanilla and pre-existing conditions with extreme variations of landlords, regional buildout costs and municipal regulatory aspects. In addition to high levels of financial negotiating experience, understanding these technical details is mandatory. If a local agent simply wants to meet at a local Starbucks to discuss an offer to prepare a letter of intent, a franchisee can be assured they are in the dark about the true financial opportunities that may exist and will overlook the most aggressive and comprehensive financial negotiating to save the most capital with the lowest rental rates.